No. 22065

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

McKee & Co., a partnership,
Plaintiff and Appellant,

vs.

First National Bank of San Diego, a national banking association,
Defendant and Appellee.

On Appeal from the United States District Court
for the Southern District of the State of California.

APPELLEE'S BRIEF

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* The Opinion of the District Court is incorporated in this Brief by reference, and all page references with an asterisk (*) are to the Record where said Opinion is set forth.

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THE FACTS OF THE CASE

The bylaw amendments in question prescribe qualifications for directors and add to information previously required to be submitted by shareholders in nominating candidates for election as directors. This additional information must show that the nominee meets the qualifications for board members. In addition, information required by the Regulations of the Comptroller of the Currency (12 C.F.R. 11.5) to be filed with the Comptroller and the Bank in election contests must also be submitted [R. 196, 197].

Appellant was notified immediately of all amendments and

submitted timely nominations accompanied by statements containing the required information. Appellant's nominations were made in full compliance with all procedural requirements [R. 197, 198].

The time for filing nominations expired on January 11, 1967, and the meeting was scheduled for January 25, 1967. Appellant claims that it had insufficient time in the six days between being notified of the amendments and January 11, 1967, to find a qualified, willing candidate. However, no effort was made in the two weeks between January 11 and the meeting to find such a candidate, and no request was made of the president to exercise his discretion to accept a late nomination [R. 158, 198], a discretion which is set forth in the bylaw itself [R. 198, 203].

SUMMARY OF ARGUMENT

The bylaws are permitted by law and are inherently reasonable on their face, even without reference to the affidavits. Motive and intent are irrelevant to the question of the validity of bylaws. Rather, bylaws are tested by the objective standard of whether they are reasonably designed to promote a legitimate end, without discrimination among persons equally situated. A discriminatory application of valid bylaws may be illegal, but no such discrimination exists in this case.

In any event, Appellant contends that the motive and intent in this case was to prevent election of *specifically* proposed nominees; and the uncontroverted affidavits [R. 63-64, 67-71 and 97-99] and Findings of Undisputed Facts [R. 198-199] clearly establish the valid purpose and good faith of the directors in protecting the Bank's reputation and strength as being a wholly local bank with knowledgeable and functioning directors, and

protecting the Bank against having directors with a potential conflict of interest with the Bank's competitors.

As for the timing of their adoption, the chairman had express discretion to accept late nominations, and Appellant made no attempt after the original deadline to find qualified nominees or seek permission to file late nominations. Rather, Appellant chose to continue with its unqualified nominees, claiming that the qualificational bylaws were invalid on their face.

Finally, Appellant's claim for money damages is in the category of special damages which are not specifically stated, either in the complaint or by affidavit. Moreover, in the matter of corporate bylaws, the approach is to balance the interests or "rights" of the corporation against those of the shareholder. The Bank's interest in this case far outweighs the limited restriction placed on the shareholders' right to nominate; and thus, Appellant is not entitled to either money damages or equitable relief.

ARGUMENT

Inasmuch as the District Court's opinion contains a thorough discussion of the issues and applicable law, for the sake of brevity said opinion is hereby incorporated by reference [R. 169-195][1] and this brief will be directed primarily to the arguments advanced and the cases cited by Appellant.

I.

The Reasonableness of the Bylaws Can Be Determined on Summary Judgment.

The opinion of the Court below cites ample authority for

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[1] The copy of the record furnished to us did not contain Pages 18 and 21 of the Opinion, which would have been designated as Pages 185a and 188 of the Record. Copies of said pages are therefore being submitted simultaneously with this Brief.

the general rule that the reasonableness of bylaws is a question of law for the court. Nevertheless, any additional facts needed to support their reasonableness in this case were before the Court in the form of the pleadings and uncontroverted affidavits. There is no issue as to the material facts set forth in the Findings of Undisputed Facts [R. 196-199] and summary judgment was therefore proper.

In *Bennett* v. *Hibernia Bank,* 47 Cal. 2d 540, 305 P. 2d 20 (1956) [Appellant's Opening Brief, p. 18], the court, in reversing the sustaining of a demurrer without leave to amend, stated that reasonableness depends on the circumstances, but also indicated that the relevant circumstances were the purposes for which the corporation was organized and the extent of the rights of the shareholder involved. The court was not referring to the motives or intention of those passing the bylaws, but of the type of *objective* facts which are apparent in most cases and which, in addition, are *established* in our case. In the *Bennett* case, the bylaw of a mutual savings bank provided for termination of membership on withdrawal of funds. The court was not satisfied, on the complaint alone, that the bylaw had a reasonable purpose. There is no indication, however, that a motion for summary judgment, supported by affidavits showing the purpose of the bank and the reasonable need for the bylaw, would not have been appropriate. There, the bylaw was quite unusual. In our case, the bylaws are inherently reasonable on their face. Moreover, the Findings of Undisputed Facts, which were not questioned by Appellant, establish the policy of the Bank and the danger which the bylaws were designed to avert. The test of legality is an objective one and the "facts and circumstances" are established in our case without the necessity of trial or the extensive discovery proceedings in which Appellant seems so anxious to engage [Appellant's Opening Brief, p. 24 and R. 137].

In fact, an almost identical situation to the *Bennett* case was before the court in *Spencer* v. *Hibernia Bank,* 186 C.A. 2d 702, 9 Cal. Rptr. 867 (1960). There, the court sustained a *summary judgment* in favor of defendant, expressly following the *Bennett* case and holding that a bylaw eliminating descendability of shares was reasonable under the circumstances, considering the purpose of the corporation and nature of the right involved. Thus, in the unusual case where the reasonableness of a bylaw might not be apparent on its face, the circumstances can be shown by affidavits. The bylaws in our case, however, are like those in the substantial majority of cases where the general rule is applicable—they are reasonable on their face and their validity is a question of law. If not, then the uncontroverted affidavits and unquestioned Findings of Undisputed Facts establish their reasonableness beyond any doubt.

II.

The Bylaws Are Reasonable in Their "Application."

A review of the cases cited by Appellant for the proposition that bylaws must be reasonable in their "application" readily demonstrates that this language refers to their *general* application, and the requirement is that they do not discriminate among persons equally situated. Any director qualificational bylaw by definition excludes some people, and the questions are whether the criteria are reasonable and whether the bylaws are *enforced* against all shareholders.

In *People's Home Savings Bank* v. *Superior Court,* 104 Cal. 649, 38 Pac. 452 (1894) [Appellant's Opening Brief, p. 15], a bylaw provided that only a shareholder of the corporation could be appointed as proxy holder. This was held invalid as contrary to § 312 of the Civil Code (now § 2225 of the Corporations Code) which provided that a shareholder may be represented

at all elections by proxy. The court stated that to give the corporation power to say who the proxy must be would give it power to throttle the statute. In saying that bylaws must not be unreasonable in their "practical application," therefore, the court was referring to their general application to all shareholders, and the bylaws were unreasonable *on their face* as repugnant to the statute.

In *Selama-Dindings Plantations, Ltd.* v. *Durham,* 216 F. Supp. 104 (D.C. Ohio 1963), aff'd. 337 F. 2d 949 (6th Cir. 1964) [Appellant's Opening Brief, p. 15], bylaws prohibiting the recording of board meetings by anyone other than management and forming an executive committee excluding minority directors were upheld in view of the disrupting antagonism at board meetings between majority and minority directors. Since the bylaws were *upheld,* there was no question of "practical application" to indicate what the quoted language meant. Moreover, the bylaws were specifically and expressly aimed at existing minority directors. Such patent discrimination should require a further factual showing to substantiate reasonableness.

Appellant cites *Lindsay-Strathmore Irrigation District* v. *Wutchumna Water Co.,* 111 C.A. 688, 296 Pac. 933 (1931), for the proposition that a bylaw adopted for the sole purpose of excluding a shareholder from enjoyment of the rights represented by his stock is invalid [Appellant's Opening Brief, p. 21]. Besides being directly contrary to the holding in the *Selama-Dindings Plantations* case immediately above, the case did not so hold. After plaintiff had acquired his stock in a water company, the sole purpose of which was to supply water to its shareholders, a bylaw was passed prohibiting use of water outside a certain area, *except* for those who were so using it at the time. At least one-third of the water was then used outside of the area and the bylaw therefore by its express terms applied *only* to the plaintiff.

The court stated that bylaws must operate equally on all persons *of the same class.* The bylaw, on its face, obviously was an invalid discrimination between persons equally situated, and the case was therefore similar to the *Yick Wo* situation discussed in the District Court's opinion [R. 189-90] where there was discriminatory enforcement of a law purporting to cover all persons. There is no such discrimination in our case, for the bylaws apply equally to all shareholders and have not been applied in an unequal or discriminating manner between persons in similar circumstances [R. 198].

III.

The Fiduciary Duty of Directors to Minority Shareholders is Simply Part of the Duty Owed to the Corporation and All Shareholders to Act in the Best Interests of the Corporation.

Section 820 of the California Corporations Code sets forth the fiduciary duty as follows:

> "Directors and officers shall exercise their powers in good faith, and with a view to the interests of the corporation."

Note that there is no requirement that the interests of minority shareholders be served. The interests of the *corporation* are paramount, and if the interests of a minority shareholder could be detrimental to the interests of the other shareholders and the corporation, it is the duty of the board to protect the interests of the majority. The cases cited by Appellant [Appellant's Opening Brief, pp. 25-26] involve economic dealings between directors and minority shareholders where the interest of the majority or the corporation is not even involved.

One of the cases cited by Appellant [Appellant's Opening Brief, p. 27] sets forth the rule very well. In *Fairchild* v. *Bank of America,* 192 C.A. 2d 252, 13 Cal. Rptr. 491 (1961), the court quotes the applicable law at p. 257:

> "In the absence of fraud, breach of trust or transactions which are *ultra vires,* the conduct of directors in the management of the affairs of a corporation is not subject to attack by minority stockholders in a suit at equity, where such acts are discretionary and are performed in good faith, reasonably believing them to be for the best interest of the corporation . . . Every presumption is in favor of the good faith of the directors. Interference with such discretion is not warranted in doubtful cases . . .
>
> "To warrant interference by a court in favor of minority stockholders . . . a case must be made out which plainly shows that such action is so far opposed to the true interests of the corporation itself as to lead to the clear inference that no one thus acting could have been influenced by any honest desire to secure such interest, but that he must have acted with an intent to subserve some outside purpose, regardless of the consequences to the company [citations omitted]."

Again, the Findings of Undisputed Facts, based on the pleadings and uncontroverted affidavits, establish without question that the directors were acting to prevent what they considered to be a danger to the Bank—to prevent persons from coming on the board with a potential conflict of interest and who would endanger the basis for the Bank's reputation and strength. Although motive is irrelevant to the question of reasonableness (see in particular the *Stockholders' Comm. for Better Man* case, discussed in the District Court's opinion, R. 186-187), the affidavits nevertheless clearly establish the valid purpose and good faith of the directors in preventing election of the *specific* candidates proposed by Appellant who posed a threat to the interests of the Bank.

Appellant states in its brief [Appellant's Opening Brief, p 28] that it has asserted that the board acted to prevent election of *any* independent directors. Such an assertion appears nowhere in the pleadings [R. 2-7, 132-134], and the bylaws on their face could not possibly accomplish such a result. They exclude only those persons with possible adverse interests, and do not prevent Appellant from nominating qualified persons.

IV.

Appellant Has Alleged No Compensable Damage.

A. Special Damages Are Not Alleged or Set Forth in the Affidavits.

Assuming, for the purposes of argument only, that Appellant has shown a wrongful act of Bank, it still has alleged no compensable damage. The complaint merely alleges general damages, and neither the complaint nor the supporting affidavits indicates the nature of the alleged damage for which $50,000 is asked [R. 134].

Rule 9(g) of the Federal Rules of Civil Procedure requires that special damages be specifically stated. The applicable rules of pleading are set forth in 22 Am. Jur. 2d, *Damages,* pp. 31-32, 366-369: General damages, as distinguished from special damages, need not be specifically pleaded. General damages are those which are the "natural and necessary" or "probable and necessary" result of the wrongful act. They must result from the wrong, directly or proximately, and without reference to the special character, condition, or circumstances of the person wronged. Special damages, on the other hand, denote such damages as arise from the special circumstances of the case. They are the natural, but not the *necessary* result of an injury. Such damages must be specially pleaded to warrant their recovery. It

must appear *from the facts pleaded* that the special damages were the direct, natural and reasonable consequence of the act complained of; and an allegation by way of conclusion that they were the direct result and consequence of the wrong is insufficient.

The $50,000 damage alleged by Appellant is obviously in the category of special damages, for it is inconceivable that monetary loss would "naturally and necessarily" result from failure to elect two of nineteen members to a board of directors for a period of only one year. There is absolutely no indication in the pleadings or affidavits as to what Appellant's alleged damage consisted of; what pecuniary profit Appellant expected to gain from one year's board representation; or any lessening in the value of Appellant's stock. In fact, insofar as events occurring subsequent to the judgment are material to this appeal [Appellant's Opening Brief, p. 7, n. 1], Appellant has sold all of its 84,670 shares for $41.50 a share, or a total of $3,513, 805, the transfer of such shares having been completed on October 23, 1967. Appellant's affidavit [R. 35 and 36] and complaint [R. 6] show that on January 9, 1967, said stock was worth approximately $2,593,000. Appellant thus made a profit of approximately $920,000 in less than a year, the value of its shares having risen from $30.63 to $41.50 per share.

(Although this question of damages was raised below [R. 93 and 155], the District Court did not pass on it since the bylaws were upheld [R. 192].)

B. Damages Are Not the Appropriate Remedy.

In the matter of bylaws regulating the internal affairs of a corporation, we are essentially dealing with conflicting interests or "rights" of individual shareholders and the corporation, or majority of the shareholders. All bylaws necessarily infringe on

the "rights" of shareholders, officers and directors; and one becomes a shareholder with knowledge that his rights are subject to reasonable restriction by the majority. The approach for determining the validity of a bylaw and the remedy is clearly set forth in the *Tu-Vu Drive-In* case, 61 Cal. 2d 283, 391 P. 2d 828 (1964), and *Spencer* v. *Hibernia Bank, supra.* The interests of the corporation and of the shareholder are to be weighed, and if the corporate interest is stronger, the shareholder's interest, or "right," must give way. There should be no doubt in this case that the interest of the Bank in having directors who reside in the banking area and have no possible conflict of interest is far greater than Appellant's interest in electing two out of nineteen directors for a period of only one year.

V.

Appellant is Entitled to No Relief Based on the Timing of the Amendments.

It is not true that a bylaw can only be waived by unanimous consent of the shareholders as claimed by Appellant. The case cited for this proposition, *Hyman* v. *Stern Co.,* 47 C.A. 605, 191 Pac. 47 (1920), dealt with a close corporation whose bylaws provided that officers' salaries were to be fixed by the board. The two sole shareholders made an oral agreement concerning salaries, with no formal board resolution. The court held the agreement enforceable. There was no mention of a *requirement* of unanimous consent of shareholders to waive a bylaw. Obviously, however, if all shareholders do waive it, the waiver is valid.

18 Am. Jur. 2d, *Corporations,* p. 704, sets forth the correct statement of the general rule—if the board has power to adopt bylaws, it has the power to waive those it has adopted.

Regardless, the bylaw in our case gives the chairman of the

annual meeting *discretion* to determine whether a nomination failing to comply with the procedural requirements is valid [R. 198]. This is set forth in the bylaw itself [R. 202]. Appellant thus had actual knowledge that a late nomination could be accepted, but made no effort to find a qualified nominee or obtain such a waiver.

In weighing Appellant's interest against the interests of the Bank, Appellant's failure, during the fourteen days after the nomination filing date and before the meeting, to make any effort to find a qualified nominee or obtain permission to file a late nomination must be taken into account. In view of the substantial interests of the Bank involved, Appellant should not be allowed to "stand pat" on its nominees [R. 171, 191], claiming that the bylaws are invalid on their face, then claim that it had insufficient time.

But even disregarding this element of the case, all that Appellant lost was the opportunity to elect two out of nineteen board members for a period of one year only. This certainly does not invalidate the bylaws for subsequent years; and balanced against the substantial interest of the Bank in protecting its reputation, strength and confidential information, this right of the Appellant for the one year in question is insubstantial.

In the *Tu-Vu Drive-In* case, 61 Cal. 2d 283, 391 P. 2d 828 (1964), the court, at p. 287, note 5, lists many important shareholder "rights," the impairment of which has been upheld by the California courts, including amendment of articles *abrogating the common shareholders' voting power* by the issuance of preferred shares (*Heller Inv. Co.* v. *Southern T. & T. Co.,* 17 C.A. 2d 202, 61 P. 2d 807 (1936)), a bylaw eliminating the right of shareholders to immediate payment of their proportionate share of the association's net worth (*DeMello* v. *Dairyman's Co-Op. Creamery,* 73 C.A. 2d 746, 167 P. 2d 226 (1946)), and a bylaw

retroactively severing the descendability feature of membership in a bank *(Spencer* v. *Hibernia Bank, supra).*

VI.

Miscellaneous Points Raised by Appellant.

Appellant raises certain points which are either completely irrelevant or erroneous, but cannot be left unanswered. The first, on p. 20 of its brief, is that on the date the amendments were adopted, Appellant could not have sold or transferred its shares to another party for nomination or voting, since the books of the Bank were already closed for voting purposes. Closing the books prior to the meeting, of course, is standard procedure and absolutely essential in order to determine who is entitled to vote. If shares are sold subsequent to that date, it is quite simple for the seller to give his proxy to the new purchaser, thus enabling him to vote. In any event, Appellant gives no reason why this fact is significant or why it makes the bylaws unreasonable.

On pp. 21-22 Appellant claims the Bank did not comply with the regulations of the Comptroller of the Currency, in that copies of the bylaw amendments were not filed with the Comptroller. There is absolutely no such requirement. The regulations quoted by Appellant state that proxy "soliciting" materials furnished to shareholders must be so filed. The bylaw amendments were not sent to shareholders and obviously were not "soliciting" material. Moreover, enforcement of the regulations rests solely with the Comptroller. Section 10.2 of the Regulations (12 C.F.R. 10.2) provides:

> "The enforcement of Parts 10, 11, 15, and 16 of this chapter shall be a function solely of the Office of the Comptroller of the Currency and no provision of the regulation in these parts (Parts 10, 11, 15, and 16 of this chapter) is in-

tended to confer any private right of action on any stockholder or other person against a national bank."

The regulation quoted by Appellant (12 C.F.R. 11.4(b)) is contained in Part 11, namely Section 11.4(b).

CONCLUSION

The principles of corporate democracy do not require that a minority shareholder be permitted to elect a director who fails to meet basic, reasonable qualifications which, in the considered opinion of the persons responsible for the strength and well-being of a bank, are essential. In the matter of bylaws, and consistent with principles of corporate democracy, the majority may make reasonable determinations governing the internal affairs of a bank, and such determinations should not be subject to veto by any minority shareholder. As stated by the court in *Stockholders' Comm. for Better Man* v. *Erie Technological Products, Inc.,* 248 F. Supp. 380, 384 (W. D. Penn. 1965), discussed at length in the District Court's Opinion [R. 186-187]: "Having chosen to embark upon a financial venture on this particular vessel, they have cast their fortunes with the rest of the shareholders on this voyage and are bound by business policies which the legally chosen representatives have taken which affect all shareholders alike."

The byaws in question apply to all shareholders equally. No attempt has been made to prevent nominations by Appellant. The purpose of the amendment is to limit nominees to persons who reside in the banking area and who will not have a conflict of interest due to any connection with another banking organization doing business in California. The standards are objective and any shareholder, including Appellant, who has sufficient votes can elect independent directors to the board.

Even assuming Appellant is correct in its contention that the

timing of the amendments deprived it of the ability to nominate, and that Appellant should not have been required to request the chairman of the meeting to exercise his discretion to accept a late nomination, the proper solution is not to compel the Bank to accept unqualified members on its board, or to award Appellant a completely arbitrary sum of money when it can show no financial loss. We are dealing with the internal affairs of a corporation and the question is not whether Appellant has been harmed or deprived of a right, for bylaws by their very nature place restrictions on the freedom of action and choice of the shareholders, officers and directors. The question is one of *how much* Appellant has been harmed and of balancing the interests of the parties. If the bylaws are reasonably designed to protect legitimate interests of the Bank, Appellant's inability for only one year to nominate two of the nineteen members of the Bank's board is certainly insubstantial in comparison.

Appellant questions the existence of the Bank's practice of having local directors. Although the affidavits of Claude C. Blakemore [R. 97-99, 159-160] eliminate any factual issue on this point (two directors who were long time employees and residents, having moved out of the county after retiring as employees, were retained on the board for a period of time—both of whom are now ineligible), the question is irrelevant; for there would be no impropriety in establishing as a completely new policy the requirement that all directors be residents of a county in which the Bank maintains an office. A determination by the board of directors that such a policy is necessary or desirable for the future welfare of the Bank would not be so unreasonable as to warrant substitution of the Court's judgment for that of the directors.

The bylaw amendments are manifestly just and reasonable, being designed to provide the Bank with a functioning, loyal

board, familiar with the banking area. There is no claim or showing that they have been or will be applied in a discriminatory manner. There is no factual dispute as to the policy sought to be promoted by the bylaws or the circumstances surrounding their adoption. This is therefore a proper case for summary judgment, both as to the future validity of the bylaws and as to their operation in the year in which they were adopted; and the District Court's judgment should be affirmed.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

/s/ C. ROBERTSON KIRKLAND